Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Cheryl Crane, Team Coordinator
Neshan Boymoushakian, Revenue Agent

from: ROBERT H. SCHORMAN, JR.
Attorney (LMSB)

subject: [redacted] **Mortgage-Backed Securities Transferred to** [redacted]

This memorandum responds to your request for written advice concerning the above-referenced transaction. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

(1) When [redacted] transfers under I.R.C. section 351 to a wholly owned subsidiary, [redacted], mortgage-backed securities (also referred to as "loans") that represent [redacted] of its qualifying loans, how does the transfer affect [redacted] reserve for bad debts under I.R.C. section 593?

(2) What are the bases in the mortgage-backed securities transferred to [redacted] and the stock received by [redacted] in the section 351 exchange?

(3) What is the federal income tax effect on recognition of loan fee income (points) as a result of the transfer of mortgage-backed securities in the section 351 transaction and under the intercompany transaction rules of former Treas. Reg. § 1.1502-13 between [redacted] and [redacted]?

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CONCLUSIONS

(1) As a result of the transfer of loans, [redacted] must reduce the balance of its bad debt reserve for qualifying loans by the amount determined by multiplying (1) the balance of the reserve immediately before the transfer by (2) the ratio of (a) the amount of loans relating to the reserve that were transferred to [redacted], to (b) the amount of [redacted] total loans relating to the reserve that were outstanding immediately before the transfer. As a result of the transfer of loans, [redacted] also must permanently reduce the balances of its bad debt reserve for qualifying loans and its qualifying loans outstanding (respectively) as of the close of its base year for purposes of applying section 585(b)(2)(B), by the amounts determined by multiplying each of these balances by the ratio described in the preceding sentence.

(2) [redacted] must reduce its basis in the transferred loans, immediately before the transfer, by the amount of the reduction in its bad debt reserve that is described in the first sentence of conclusion 1. Immediately after the transfer, [redacted] has a carryover basis in the transferred loans that is equal to [redacted] basis in the loans immediately before the transfer (reduced as referred to in the preceding sentence). Immediately after the transfer, [redacted] basis in the stock of [redacted] that [redacted] receives in the section 351 transaction is equal to [redacted]'s carryover basis in the transferred loans immediately after the transfer.

(3) [redacted] must recognize the remaining deferred loan fee income on the loans it transferred in the section 351 exchange at the time of the exchange. The recognition of deferred loan fee income is not subject to the intercompany transaction rules of former Treas. Reg. § 1.1502-13.

SUMMARY OF FACTS

[redacted] a Delaware corporation, owned approximately [redacted] subsidiaries, which were principally engaged in [redacted].

[redacted]'s principal [redacted] subsidiary, [redacted], was a federally chartered savings bank and had been owned by [redacted] for a number of years. [redacted] was regulated by the Director of the Office of Thrift Supervision ("OTS") and the Federal Deposit Insurance Corporation ("FDIC"). [redacted] was further subject to regulations of the Board of Governors of the Federal Reserve System.

[redacted] purchased the stock of [redacted] ("[redacted]") from an unrelated taxpayer in [redacted]. [redacted] transferred a total of $[redacted] of mortgage-backed securities to [redacted] in a series of three section 351 exchanges in [redacted], [redacted] and [redacted] (collectively referred to hereinafter as "the section 351 exchange"). After each exchange, [redacted] owned [redacted] shares or [redacted]% of the outstanding voting common stock of [redacted]. [redacted] has [redacted]. Thus, [redacted] [redacted]% of the total combined voting power and [redacted]% of the total number of shares of stock in [redacted] immediately after each exchange.

The mortgage-backed securities constituted [redacted]% of the total outstanding loans and [redacted]% of qualifying loans in [redacted] loan inventory for which [redacted] maintained reserves. Only qualifying loans were involved in the transaction. The securities are considered loans for purposes of computing deductions for additions to a bad debt reserve under I.R.C. § 593. [redacted] was not eligible to maintain a bad debt reserve under section 585 or 593 because it was not a bank or other eligible financial institution. However, it could use the specific charge-off method of accounting for bad debts pursuant to section 166(a).

Following the section 351 exchange, [redacted] was engaged in the business of managing a mortgage-backed securities investment portfolio. According to the taxpayer, [redacted] was capitalized to provide future financing opportunities for [redacted]. Both [redacted] and [redacted] use the accrual method of accounting and have tax years ending on December 31.

[redacted] earned income from points charged with respect to the loans underlying the mortgage-backed securities. Points are typically regarded as a charge paid for the use of money. In this case, the points were treated as <u>de minimis</u> original issue discount. The lender is allowed to account for <u>de minimis</u> original issue discount by recognizing it as income as principal is collected ratably over the life of the loan. The Service has developed special procedures for recognition of such points income.

[redacted] used the composite method to amortize points into income prior to the issuance of Rev. Proc. 94-29, 1994-1

C.B. 616 and Rev. Proc. 94-30, 1994-1 C.B. 621. In [redacted], [redacted] filed an election under Rev. Proc. 94-29 to change to the principal-reduction method of accounting ("PRM"), an aggregate method of accounting for de minimis original issue discount on loans originated by the taxpayer, with a cutoff date of [redacted]. For loans originated prior to this cutoff date, they elected the revised loan liquidation method pursuant to Rev. Proc. 94-30.

Attendant to the section 351 exchange, [redacted] purported to transfer the deferred points income it had not yet recognized to [redacted] as follows:

Pre-[redacted] Deferred Fees (Rev. Loan Liquidation)	$[redacted]
Post-[redacted] Deferred Fees (PRM)	[redacted]
	$[redacted]

[redacted] purported to use the revised loan liquidation and PRM methods for the loans transferred to it until [redacted] when [redacted] acquired [redacted], the parent of [redacted] and [redacted]. From the time of the section 351 exchange until the acquisition of [redacted] and its subsidiaries by [redacted], [redacted] recognized $[redacted] of the points income. The remaining $[redacted] of points income was purportedly transferred to [redacted].

The examination team issued an IDR to the taxpayer asking it to explain why the taxpayer should be allowed to use the principal-reduction method for loans it did not originate when Rev. Proc. 94-29 specifically restricts the use of PRM to loans acquired by the taxpayer at origination. The taxpayer responded to the IDR as follows:

[redacted]

LEGAL ANALYSIS

Effects of Section 351 Exchange on Bad Debt Reserve and Basis

Prior to 1996, I.R.C. § 593 allowed mutual savings banks, domestic building and loan associations and cooperative banks to use bad debt reserves. The statute allowed a thrift to use the experience method of determining the reasonable addition for the taxable year to the reserve for bad debts as set forth in I.R.C. § 585(b)(2). [redacted] used the experience method.

We must first consider how the section 351 transaction affected [redacted] reserve for bad debts under section 593. We will also consider determination of the bases of the mortgage-backed securities transferred to [redacted] and the stock received by [redacted].

In Nash v. United States, 398 U.S. 1 (1970), the Supreme Court considered the question of whether transferors in section 351 exchanges would have to include in income the amount of accumulated, unused bad debt reserves associated with transferred accounts receivable pursuant to the tax benefit rule.

In Nash, the taxpayers were partners in a partnership using the accrual method of accounting and the reserve method of treating bad debts under section 166(c) of the Code. The reserve for bad debts was deemed reasonable. The assets of the partnership, including accounts receivable, were transferred solely in exchange for corporate stock in a transaction qualifying for nonrecognition of gain or loss under the provisions of section 351. The value of the stock received in exchange for the accounts receivable was equal to the *net* value of the accounts transferred, i.e., the face amount of the accounts receivable previously included in income less the amount of the reserve for bad debts.

The Supreme Court held that although the need for the reserve ended with the transfer, this did not result in a recovery within the meaning of the tax benefit cases. That is, there was no recovery of an item that had produced an income tax benefit in a prior year and therefore nothing had to be added to income in the year of the transfer.

Essentially, the decision in Nash holds that because there is no double benefit if the consideration received in exchange for the transfer of accounts receivable by a taxpayer using the accrual method of accounting is equal to the *net* value of the accounts receivable (the face amount of the accounts receivable previously included in income less the reserve for bad debts), there is no recovery within the meaning of the tax benefit cases. The Nash case did not involve the determination of the transferor's and transferee's bases in the accounts receivable for the purpose of applying sections 358(a)(1) and 362(a) of the Code.

In short, the taxpayer in <u>Nash</u> did it right--by treating as transferred only the net amount of the accounts receivable. In contrast, in the present case, [redacted] has purported to transfer the gross amount of the bank's loans.

Relying on the <u>Nash</u> decision, Rev. Rul. 78-280, 1978-2 C.B. 139, sets forth the method for determining the transferor's and the transferee's bases in accounts receivable transferred in a section 351 transaction where the transferor uses the reserve treatment for bad debts. The ruling also explains how the transferee should treat the transferred accounts receivable if it uses the reserve method of accounting or if it uses the specific charge-off method of accounting for bad debts.

In accordance with <u>Nash</u>, the Service ruled that the transferor's bad debt reserve reduces the basis of the accounts receivable to which it relates. Thus, the transferor's basis in the accounts receivable is equal to their *net* value, to wit: the face amount less the amount of the reserve for bad debts allocable to the accounts receivable transferred. Under section 362(a), the basis of property received by the corporation in a section 351 exchange is the same as it would be in the hands of the transferor. The transferee corporation would have a basis equal to the *net* value of the accounts receivable pursuant to section 362(a). Since section 358(a)(1) provides that the basis of stock received by the transferor in a section 351 exchange is the same as that of the property exchanged, the transferor would also have a basis equal to the *net* value of the accounts receivable in the stock received.

The purpose of reducing the transferor's basis in the accounts receivable by the amount of the bad debt reserve is to prevent a double deduction, as noted by the Service:

> "Furthermore, in the present situation, because the transferor has already deducted additions to the bad debt reserve with respect to the accounts receivable and because under <u>Nash</u> the amount of the bad debt reserve is not includible in income at the time of transfer, it is necessary to prevent the transferee from also taking a deduction with respect to the accounts receivable. The reduction of their aggregate basis by the amount of the bad debt reserve prevents this double deduction. <u>See</u> <u>Charles Ilfeld Co. v. Hernandez</u>, 292 U.S. 62 (1934), XIII-1 C.B. 139 (1934)." Rev. Rul. 78-280, <u>supra</u>, 1978-2 C.B. at 140.

With respect to a transferee corporation that uses the specific charge-off method, the Service ruled that in the absence of evidence to the contrary, it will be presumed that the basis of each of the transferred accounts receivable as of the date of the transfer will be the same fraction of its face amount (i.e., the outstanding loan balance) as the total basis of all such accounts receivable, as determined under section 362(a), is to the total face amount. This same fraction of any amount collected with respect to such an account receivable will be a return of basis, and the remainder of the amount collected will be gain. If the account receivable becomes totally worthless, the transferee corporation would be entitled to a deduction under section 166(a) of an amount equal to its basis in the account receivable less any recovery. It is this approach that is relevant to the instant case, since [redacted] used the specific charge-off method.[1]

Rev. Rul. 80-270, 1980-2 C.B. 200, follows Nash and reaffirms Rev. Rul. 78-280, supra.[2]

The foregoing authorities provide guidance on the proper treatment of [redacted] bad debt reserve and the bases of the transferred mortgage-backed securities and the stock received by [redacted] in the section 351 exchange.

Nash, Rev. Rul. 78-280 and Rev. Rul 80-270 require that [redacted]

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[1]Not relevant to the instant case, the Service ruled that if the transferee corporation uses the reserve method of treating bad debts, it must establish a nondeductible bad debt reserve equal in amount to that previously used by the transferor with respect to the transferred accounts receivable. Amounts collected by the transferee in excess of its basis will not result in income inclusion and amounts collected that are less than its basis will not entitle it to specific charge-offs. Rather such transactions will be reflected in the transferee's determination of a reasonable reserve for bad debts in future periods.

[2]In this revenue ruling, the Service held that a bank that transferred a portion of its loans outstanding to another bank in a transaction qualifying under section 351 of the Code must consider the transferred loans as a reduction in eligible loans outstanding at the beginning of the year of transfer in calculating the maximum addition to its reserve for losses on loans at the end of the taxable year of transfer under the "percentage method" that was in effect before 1991. While this issue is not relevant to the present case, Rev. Rul. 80-270 is significant in that it evidences a consistent application of the Nash approach.

[redacted] reduce its bad debt reserve related to its qualifying loans by an amount which is in direct proportion to the ratio of the qualifying loans transferred to the total amount of qualifying loans in [redacted] inventory immediately before the transfer. In other words, [redacted] must reduce the balance of its bad debt reserve by the amount determined by multiplying (1) the balance of the reserve immediately before the transfer by (2) the ratio of (a) the amount of loans relating to the reserve that were transferred to [redacted] to (b) the amount of [redacted] total loans relating to the reserve that were outstanding immediately before the transfer.

Immediately after the transfer, [redacted] has a carryover basis in the transferred loans that is equal to [redacted] basis in the loans immediately before the transfer (reduced as referred to in the preceding sentence). Immediately after the transfer, [redacted] basis in the stock of [redacted] that [redacted] receives in the section 351 transaction is equal to [redacted]'s carryover basis in the transferred loans immediately after the transfer.

[redacted] used the experience method of section 585(b)(2) to calculate its annual deductible addition to its bad debt reserve. Section 585(b)(2) generally allows an institution using the experience method to increase its bad debt reserve to the greater of (i.) its six-year moving average amount or (ii.) its base year amount. Section 585(b)(2)(A) provides that the six-year moving average amount is calculated by multiplying the balance of the institution's loans outstanding at the close of the current tax year by its average loss experience ratio. The ratio is calculated by comparing the amount of the institution's total bad debts for the current and five preceding taxable years to the sum of the loans outstanding at the close of each of those years. The base year amount is the amount of the institution's bad debt reserve at the end of [redacted]. If, however, the institution's amount of loans outstanding at the close of the taxable year is less than the amount outstanding at the close of the base year, the base year amount is treated as reduced proportionately for that year. Section 585(b)(2)(B).

Section 585(b)(2)(B), which establishes rules governing base year amounts, was added to the Code by the Tax Reform Act of 1969 at the same time that Congress substantially reduced the magnitude of the bad debt reserve deductions available for banks. A principal effect of the base year amount is to allow a financial institution to deduct its actual bad debt losses each year even when its reserve exceeds the amount based on its six-year moving average amount. In the instant case, failure to reduce [redacted] base year amount would cause [redacted] to benefit from any reduction in its reserve. After the transfer [redacted] loan amount will still be larger than its [redacted] amount. If [redacted] base year amount is not cut back, but its bad debt reserve is reduced, [redacted] will be able to take a deduction in the year of the transfer to restore its debt reserve to the base year amount.

In view of the foregoing, the rationale of the statutory scheme mandates that [redacted] should permanently reduce the balances of its bad debt reserve and loans outstanding (respectively) as of the close of its base year for purposes of applying section 585(b)(2)(B), by the amounts determined by multiplying each of these balances by the ratio of (a) the amount of loans relating to the reserve that were transferred to [redacted], to (b) the amount of [redacted] total loans relating to the reserve that were outstanding immediately before the transfer.

Effect of Section 351 Exchange and Intercompany Transaction Rules on Recognition of Loan Fee Income

The question presented is what effect did [redacted] section 351 exchange and the intercompany transaction rules of former Treas. Reg. § 1.1502-13 have on the recognition of de minimis original issue discount ("OID") associated with the transferred loans.

Both the principal-reduction method, as set forth in Rev. Proc. 94-29, 1994-1 C.B. 616, and the revised loan liquidation method, as set forth in Rev. Proc. 94-30, 1994-1 C.B. 621, require that the taxpayer recognize de minimis OID based on reductions in the total amount of loan principal outstanding during a given time period. It does not matter how the loans are disposed of, the formulas used require the taxpayer to recognize discount income when the total principal amount of the loans decreases during the applicable accounting period. This would be true even if the taxpayer simply gave away the loans. The income recognition is simply a function of these accounting methods. As a consequence, the taxpayer, [redacted], should have recognized as income all de minimis OID associated with the transferred loans at the time of the transfer.

Moreover, Rev. Proc. 94-29 specifically states:

> "The principal-reduction method (described in section 5 below) applies only to loans that-
> (1) Are acquired by the taxpayer at origination, ..." p. 618.

Similarly, Rev. Proc. 94-30 only applies to loans acquired before the applicable cut-off dates specified in Rev. Proc. 94-28, 1994-1 C.B. 614 or Rev. Proc. 94-29. Because [redacted] was not the originator of the loans transferred to it, it could not use either the principal-reduction method or the revised loan liquidation method to account for de minimis OID income.

The fact that part of [redacted] loans were transferred to [redacted] in a section 351 exchange does not change the foregoing conclusions.

Section 351 generally provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation, as defined in I.R.C. § 368(c). I.R.C. § 351(a).

In the instant case, no gain or loss was recognized as a result of the exchange of the loans for stock of [redacted]. The required recognition of the points income by [redacted] is solely a consequence of its use of the principal-reduction method and the revised loan liquidation method. It is not gain from the exchange of the loans for stock. If [redacted] had simply sold or exchanged the loans, it would have recognized gain or loss on the sale or exchange depending upon the amount realized and its adjusted basis in the loans. I.R.C. 1001(a). No such gain or loss was recognized in the loan transfer due to the nonrecognition provisions of section 351.

Furthermore, although section 381 provides carryover treatment for such attributes as method of accounting in the case of certain specified nonrecognition transactions, it does not apply to a section 351 transaction such as occurred in the instant case. In a typical section 351 transaction , "the transferee corporation is neither required nor permitted to take over the tax attributes of its transferors, other than the basis and holding periods of properties transferred to it in a § 351 exchange." B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders (7th Ed. 2000) ¶ 3.18[2].

On February 1, 1999, the Treasury proposed that the transferor's method of accounting will carryover in section 351 transactions as if section 381(c)(4) applied to the date of the transfer (effective on date of enactment). Id. at ¶ 14.23[a], footnote 93. This proposal was apparently part of President Clinton's proposed fiscal 2000 budget. JCT Describes President's Fiscal 2000 Budget (Part 2 of 2), 1999 Tax Notes Today 37-12 [Part 2 of 2] (February 25, 1999). The taxpayer could not argue that it relied on this proposal because the capital infusions occurred in [redacted]. Moreover, no proposed regulations embodying this proposal have been issued.

The taxpayer's explanation of its inappropriate use of the PRM method is simply obfuscation. While the section 351 exchange was an intercompany transaction, any deferred gain would be due to the disposition by [redacted] of the loans for an amount greater than the carryover basis it received in the loans in the section 351 exchange. I.R.C. section 362(a). There would be no deferred gain due to recognition of deferred loan fees by [redacted] to which former Treas. Reg. § 1.1502-13 would apply.[3]

In view of the foregoing, [redacted] should recognize as ordinary income the deferred loan fees purportedly transferred to [redacted] in [redacted]. Adjustments should be made decreasing the income of [redacted] for the taxable year [redacted] and every other year in which it reported deferred loan fee income by the amount of the reported loan fee income due to the transferred loans. Similar reductions should be made to [redacted]'s income for taxable years beginning in [redacted] if it reported the deferred loan fees as income.

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[3] The current regulation applies to transactions occurring in years beginning on or after July 12, 1995.